Internal Revenue Service

memorandum

CC:TL:TS
CWILSON

date: 02 NOV 1987

to: Chief, Tax Shelter Section EX:C:T

from: Chief, Tax Shelter Branch CC:TL:TS

---

subject: Frozen Refunds of TEFRA Investors

This memorandum responds to your August 31, 1987 request for technical advice on the above-referenced matter.

ISSUE

May the refunds of TEFRA partners or subchapter S shareholders be "frozen" and, if so, after what period of time may those taxpayers sue for a refund?

CONCLUSION

Refunds of TEFRA partners and subchapter S shareholders may be "frozen" in accordance with Temp. Treas. Reg. §§ 301.6231(c)-1T and 301.6231(c)-2T and Rev. Proc. 84-84, 1984-2 C.B. 77. TEFRA partners and shareholders whose refunds are "frozen" may wait one year from the date the partnership return is filed and then elect to treat their partnership items as nonpartnership items. Once that election is made, a suit for refund may be filed anytime after the earlier of the expiration of 6 months from the date the claim for refund is filed or after the claim is denied.

FACTS

Under Rev. Proc. 83-78, 1983-2 C.B. 595 and Rev. Proc. 84-84, portions of refunds attributable to abusive tax shelters determined to be subject to penalties under section 6700 are frozen. The freezes usually result from the issuance of Pre-Filing Notification letters or by approval of the Assistant Commissioner (Examination) on cases identified by the Abusive Tax Shelter Detection Teams in the Service Centers. In subsequent years, the portions of any refunds attributable to the same abusive shelters are frozen and offset by adjustments made when the key case is examined.

ANALYSIS

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) enacted significant procedural changes with respect to tax controversies involving partnerships. Ordinarily, under the partnership audit rules (I.R.C. §§ 6221-6233), the I.R.S. may adjust the treatment of partnership items by a partner who reported those items consistently with the partnership return only through partnership-level proceedings. Sections 6241 through 6245 provide for parallel audit rules for subchapter S corporations.

Pursuant to section 6244, the partnership audit provisions relating to assessing deficiences, and filing claims for credit or refund with respect to partnership items are extended to and made applicable to subchapter S items (except to the extent made inapplicable or modified in regulations). Accordingly, the following discussion relating to partners and partnerships will apply to subchapter S shareholders and corporations unless expressly stated otherwise.

Generally, partners are notified of adjustments to a partnership item through a notice of Final Partnership Administrative Adjustment. I.R.C. § 6223(a)(2). Section 6225(a) states that no assessment of a deficiency attributable to any partnership item may be made before the close of the 150th day, after the day on which a notice of Final Partnership Administrative Adjustment was mailed to the tax matters partner. If a proceeding is begun in the Tax Court under section 6226 during the 150 day period, no such assessment may be made until the decision of the Tax Court becomes final.

The restriction on assessments with respect to partnership items in section 6225 differs from the rule with respect to nonpartnership items in section 6213. While section 6213(a), generally precludes assessments of a deficiency for 90 days after notice of the deficiency is mailed to the taxpayer (or until a decision of the Tax Court becomes final where a petition is filed with the Tax Court), section 6213(b)(3) provides a summary procedure for assessment prior to sending a notice of deficiency in the case of applications under section 6411 for tentative carryback or refund adjustments. Section 6225 provides no such exception with respect to partnership items.

[redacted]
(b)(5)(DP), (b)(7)a

(b)(5)(DP), (b)(7)a

(b)(5)(DP), (b)(7)a

Section 6231(c) provides that with respect to areas presenting "special enforcement consideration" the Secretary may provide by regulation for treatment of items as nonpartnership items for purposes of sections 6221-6233 where treatment as partnership items would interfere with the effective and efficient enforcement of the tax laws. Based on the reasons set forth in T.D. 7996, the Commissioner has determined that "special enforcement consideration" within the meaning of section 6231(c) exists in the case of certain applications under section 6411 (relating to tentative carryback and refund adjustments) and claims for credit or refund based on losses, deductions, or credits of a partnership. Those considerations exist if the Commissioner determines it is highly likely that a person described in section 6700(a)(1) made, with respect to the partnership giving rise to the losses, deductions, or credits, a gross valuation overstatement, or a false or fraudulent statement with respect to the tax benefits to be secured by reason of holding an interest in the partnership that would be subject to a penalty under section 6700. Section 6700 provides for penalties against promoters of abusive tax shelters.

In response to the special enforcement considerations outlined in T.D. 7996, Temp. Treas. Reg. §§ 301.6231(c)-1T and 301.6231(c)-2T were issued on December 13, 1984. Section 301.6231(c)-1T pertains to applications under section 6411. Generally under section 6411, the Secretary has 90 days to make a limited examination of an application for a tentative carryback adjustment to discover any computation errors and the amount of decrease in tax attributable to the carryback. Any resulting decrease should be applied, credited, or refunded within that same time period. Treas. Reg. 1.6411-3(d)(3). Where the Secretary determines that the amount applied, credited or refunded under section 6411 exceeds the over assessment attributable to the carryback, however, the Secretary may assess the amount of the excess as a deficiency as if it were due to a mathematical or clerical error. This can be done without regard to whether the taxpayer has been mailed a notice of deficiency and without regard to the restrictions on assessments in section 6213(a). Treas. Reg. § 301.6213-1(b)(2). This summary

assessment procedure allows the Service to offset the refund against the tax assessed and is intended to restore the Service and the taxpayer to the position occupied prior to the approval of the application for tentative carryback adjustment. See, H.R. Rep. No. 849, 79th Cong., 1st Sess.(1945), 1945 C.B. 566, 583.

Section 301.6231(c)-1T provides that in the case of an application for tentative carryback adjustment based on the losses, deductions, or credits of a partnership, the Service may make an assessment under the summary procedures of section 6213(b)(3) to offset or recover any refund. This provision applies, however, only if the Commissioner determines that it is highly likely that a person described in section 6700(a)(1) made with respect to the partnership, a gross overvaluation statement or a false or fraudulent statement with respect to the tax benefits to be secured by reason of holding an interest in the partnership that would be subject to a penalty under section 6700. Thus, notwithstanding the restriction in section 6225(a) on assessment prior to issuance of Notice of a Final Partnership Administrative Adjustment, the Service may make an adjustment in accordance with sections 301.6231(c)-1T and 6213(b)(3) in the case of applications for tentative carryback adjustment under section 6411.

Notice of the assessment pursuant to section 301.6231(c)-1T must be mailed to the affected partner. That notice must inform the partner of its right to elect to have all partnership items from the partnership taxable year giving rise to the losses, deductions or credits treated as nonpartnership items. Temp. Treas. Reg. § 301.6231(c)-1T(d)(1). Such an election cannot be made until one year after the partnership return is filed, but must be made before the Service mails the Notice of Final Partnership Administrative Adjustment to the tax matters partner. Temp. Treas. Reg. § 301.6231(c)-1T(d)(2).

Section 301.6231(c)-2T pertains to claims for credits or refunds based on losses, deductions or credits of partnership. Like section 301.6231(c)-1T, it applies only when the Commissioner determines that it is highly likely that a person described in section 6700(a)(1) made, with respect to a partnership, a gross valuation overstatement, or a false or fraudulent statement with respect to tax benefits to be secured by reason of holding an interest in the partnership that would be subject to a penalty under section 6700. Any income tax return requesting a credit or refund is treated as a claim for a credit or refund. Temp. Treas. Reg. § 301.6231(c)-2T(a).

When a claim is made that falls within section 301.6231(c)-2T(a), the Service may notify the partner that no action will be

taken on the claim until the partnership-level proceedings are completed. The partner has the right, within the same time period as in section 301.6231-1T(d), to elect to treat all partnership items for the partnership taxable year as nonpartnership items. Temp. Treas. Reg. § 301.6231-2T(d)(2).

The right of a partner who has had its refund offset or its refund claim suspended to treat all partnership items as nonpartnership items insures that a partner is not denied access to a court with respect to those items for an unreasonable period of time. A partner making such an election will enjoy the same rights with respect to items arising from the partnership as the partner enjoys with respect to other nonpartnership items. For example, an electing partner may file a refund suit if the Service has failed to grant a refund claim for those items within six months. Section 6531. To protect the Secretary from facing immediate statute of limitations problems, section 6221(f) provides that the period for making assessments will not expire for one year after the date on which any partnership item becomes a nonpartnership item.

Rev. Proc. 84-84, 1984-2 C.B. 77 sets forth the procedures the Service will follow in implementing Temp. Treas. Reg. §§ 301.6231(c)-1T and 301.6231(c)-2T. It provides that District Directors shall make the determination of whether it is highly likely there is a gross valuation overstatement or a false or fraudulent statement for purposes of sections 301.6231(c)-1T and 301.6231(c)-2T in cases were a pre-filing notification letter is sent. Where no pre-filing notification letter is sent, a recommendation on the determination is made by the Section 6700/7408 Committee to the Executive Committee consisting of the Assistant Regional Commissioners (Examination). The Executive Committee then refers those tax shelter entities or arrangements that it considers potentially abusive to the Associate Commissioner (Examination) who makes the final "highly likely" determination.

Based on the foregoing authority, a TEFRA partner or subchapter S corporation shareholder whose refund has been frozen must wait one year from the date the partnership return is filed before electing to treat all partnership items as nonpartnership items. Once that election is made, the partner is in the same position, and subject to the same time limitations, as a non-TEFRA partner. A suit for refund may then be filed after the earlier of the expiration of 6 months form the date the claim for refund was filed or after the claim for refund was disallowed.

Kathleen E. Whatley

KATHLEEN E. WHATLEY